Journal of Accountancy

Volume 49 | Issue 5 Article 7

5-1930

Correspondence: Misnomer Begets Misunderstanding

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MISNOMER BEGETS MISUNDERSTANDING

Editor, THE JOURNAL OF ACCOUNTANCY:

SIR: There has been much discussion and much litigation on the subject of stock dividends, and, like all questions involving principles of right and justice in the dealings of man with man, this one will not be settled until it is settled aright. Questions of this sort often turn on a point of the use and meaning of words. This is merely one of a number of instances in which the terms used in the accountancy profession are ambiguous or misused.

The word "dividend" may mean a separated portion of the thing of which it was a part or it may mean, in common parlance, and by a misuse of the word, a distribution among several persons of some severable thing. In the financial world the word dividend has been so restricted to mean distribution that the word "split-ups" now begins to be used to indicate what the word dividend formerly meant.

"Stock dividend" in its current meaning is a misnomer. It implies neither of the acts mentioned. The ownership which a stockholder has in the accumulated earnings of a corporation is already separated as far as it can be separated by means of the issuance of certificates, and it can not be parceled out and distributed to him, because it is already his.

It is in no sense of the word a dividend. The certificate which he holds is not cut into pieces, and the property represented by the certificate is not severed into parts. It is a replacement of one form of evidence of ownership by another.

The adoption of the term "stock dividend" was doubtless a device intended to deceive. The managers of a corporation with an accumulation of earnings which had perhaps already been reinvested in assets of the business, being reluctant to convert these into cash and distribute to the stockholders, hit upon the scheme of withholding the earnings, and at the same time giving to the stockholders, other pieces of paper representing their individual share of the profits, as distinguished from their original investment, and thus to silence their clamor. So they gave them paper, additional receipts for what was already theirs, and called the paper "dividends." Rightfully, also, it was a device for reducing the apparent rate of dividends. In both instances deception seemed necessary, and in both instances it was thought necessary because of the falseness inherent in par certificates.

One who sells his shares in a corporation surrenders his certificate and permits his ownership to pass by endorsement. It is not the certificate which he sells; it is the property evidenced by it.

Capital stock is not a credit; it is a debit on the balance-sheet. The offsetting account is a credit to owners for the capital stock, the stock in trade, which they put into the business. It is a credit for capital stock, and not the capital stock.

A decedent leaving his stock to a remainderman, but the income therefrom to a life-tenant, leaves what to the remainderman? He leaves whatever share he possesses at the date of his death in the net assets of the corporation.

Suppose, for example, that X leaves to his son his stock in the Blank corporation with the provision that the income therefrom shall go to his daughter while she is in college and until she marries. Mr. X, and even his lawyer who helps draft his will, in fact most testators, can not be charged with a foresight so penetrating as to perceive and guard against the multiplicity of probable acts on the part of the corporation.

Is it not reasonable and right to hold that any surplus undistributed at the date of the death of the testator inheres in and is a part, not of the capital stock which is the original investment represented by the stock certificates, but of the share of the business which he owned when he died?

The remainderman falls heir to that share including both the elements of original investment and undistributed prior earnings. Whatever this entire share earns in the future should go to the life-tenant.

Suppose that at the death of X the shares stood at $100 original investment and $80 undivided surplus. Would not common sense decide that the remainderman was heir to $180 of interest in the business for each share inherited by him?

Suppose that the future earnings were only partly distributed. Could not the life-tenant justly lay claim to the undistributed part? Whether profits are declared and paid as dividends or retained in surplus, is it not reasonable to conclude that the testator meant the life-tenant to have them?

Suppose the undistributed part accumulated until the value of the shares became $200, and that then a stock dividend of one hundred per cent was made in the usual fashion. Is it not reasonable to hold that $80 of this constitutes corpus and should be held as property of the remainderman and $20 is income belonging to the life-tenant? If these extra shares are marketable and are sold, should not $80 of the proceeds be reinvested and treated as the original shares would have been treated if they were sold?

Mere rise in the market price of the original shares, uninfluenced by undistributed earnings, or a mere rise in the market price of the actual property of the corporation other than the property in which it deals, represented by the certificates, might be considered an increase of corpus, as distinguished from earnings, unless the enterprise was speculative in nature, dealing in fluctuations, when such increase would necessarily be treated as earnings, only when realized.

A corporation which earns fifty per cent per annum on its net worth may enjoy a high market price for its stock. Such a condition benefits the life-tenant. The remainderman must accept conditions as he finds them when he comes into full possession of both corpus and income. The market price at which a share may be sold is quite distinct from the value of the share, that is, the undivided interest in the net assets of a business, not the certificate itself nor the capitalized earning power. The fact that a man may, or even does, take advantage of a current opinion that a share is worth more than it cost him, and may realize a profit, does not demonstrate that the share as such is worth so much. His profit, when realized, is income to him, but it may be loss to the vendee. Hence market price is beside the question, and should never be allowed to lift our eyes from the share itself.

If X leaves a farm to his son, the income to go to the daughter, any increase in the market price of the farm would doubtless be increase of corpus, but, as has been pointed out, this should not be entered upon the books of the remain-

derman until after the life-tenant is out of the picture and the remainderman actually realizes such increase by sale of the property.

Court decisions should not be accepted as basic and final when considering questions of this sort. Truth does not change. Court decisions are reversed. The supreme court of the United States has reversed its own decisions, and it may yet reverse the age-old decision in the case of *Gibbons* v. *Mahon* (136 U. S. 549, 557). That case involved the rights of two daughters of Mrs. Ann W. Smith, who left two hundred and eighty shares of Washington Gas Light Co., forty-five shares of Franklin Insurance Co., and $80,500 in government bonds to her daughter, Mrs. Jane Owen Mahon, in trust for the benefit of herself and her sister, Mrs. Mary Ann Gibbons, with the provision that Jane should "cause the dividends of said stock and the interest of said bonds as they accrue to be paid to my said daughter, Mary Ann Gibbons, during her lifetime, and in case of her death, said stocks, bonds and income shall revert to the estate of my said daughter, Jane Owen Mahon."

The gas company paid a stock dividend and both daughters claimed it. They went to court, and such was the swift movement of the machinery of justice that the case was decided twenty-five years later, and the decision was that the earnings which the company withheld were increase of capital and therefore belonged to Jane.

No one doubts that Mrs. Smith thought that all earnings of the company would be paid in dividends, and that it was her intention that Mary should receive all the earnings of the principal. Yet the court said: "The tenant-for-life of stock is entitled to all dividends declared thereon during his life, irrespective of the time when they were earned, provided only that they do not impair the capital of the trust fund."

We are bound by our form of government to give full reverence to the decisions of our courts on questions of what is law. But in the name of our boasted freedom are we by such reverence to be bound and diverted from the right path in our quest of truth?

The question as to whether a stock dividend is taxable may be a question of what is law, but the question of whether or not it is income is a question of what is the fact.

The decision in *Macomber* v. *Eisner* that stock dividends are not income was handed down by the amazing vote of five to four. If one of the five had changed his opinion as to what was the fact, would that have changed the fact? Shall we say with Catherine Manola, "If thou sayest it is the sun, it is the sun, and if thou sayest it is but a candle light, it is so, and if thou sayest it is the moon, it is the moon. Whatever thou sayest it is, that it is"? Can a decision by a majority of one out of nine make the moon the sun?

Yours truly,

ERNEST S. RASTALL.

Rockford, Illinois, March 25, 1930.

STOCK DIVIDENDS

Editor, THE JOURNAL OF ACCOUNTANCY:

SIR: I have read, with great interest, the editorial comment appearing in the editorial columns of the February, 1930, issue on the subject of stock dividends, the reply thereto written by your correspondent, Herbert C. Freeman, appearing

in the April, 1930, issue of the JOURNAL, as well as the more lengthy dissertation on the subject, written by Professor Briggs and entitled "Stock Dividends—Life-tenant or Remainderman," which appeared in the March, 1930, issue.

It would seem from a study of Professor Briggs' interesting article that the present law in New York on the subject is that laid down by Judge Chase, speaking for the court of appeals in *Matter of Osborne* (1913), 209 N. Y. 450, a leading case in this state, which follows the so-called Pennsylvania or American rule in that, in order to keep the corpus of a trust fund intact in cases where the declaration of an extraordinary dividend would encroach upon the capital of the trust fund, in whole or in part, it directs an equitable apportionment of such dividends (whether payable in cash or stock) between principal and income in accordance with the method of computation stated in the opinion. However, the rule enunciated in *Matter of Osborne* (supra) is not the law in New York, today, for all purposes.

A statutory enactment, effective May 17, 1926 (Laws of 1926, chapter 843, amending paragraph 17-A of the personal-property law), provides as follows:

> 17-A. STOCK DIVIDENDS. Unless otherwise provided in a will, deed or other instrument, which shall hereafter be executed and shall create or declare a trust, any dividend which shall be payable in the stock of the corporation or association declaring or authorizing such dividend and which shall be declared or authorized hereafter in respect of any stock of such corporation composing, in whole or in part, the principal of such trust, shall be principal and not income of such trust. The addition of any such stock dividend to the principal of such trust, as above provided, shall not be deemed an accumulation of income within the meaning of this article.

The present law thus expressly overrules the decision in *Matter of Osborne* (supra) as to stock dividends and declares that in the absence of a provision to the contrary in the instrument creating the trust, any stock dividend duly received by a trustee of a trust created after the effective date of this enactment, "shall be principal and not income of such trust." By its broad terms, this provision would seem to include all stock dividends, whether ordinary or extraordinary in character—the sole criterion being the form in which the dividend was declared. The statute thus adopts the so-called Massachusetts rule.

Judicial interpretations of this statute, above set forth, have again declared it to be applicable only in cases where the trusts, holding the stocks, upon which the stock dividend was declared, were created after the focal date, viz., May 17, 1926. See, *Equitable Trust Co.* v. *Prentice* (1928), 250 N. Y. 1; also *In re Lawton's Will* (1929), 133 Misc. 820, 234 N. Y. S. 494; also, *Matter of Norton*, 129 Misc. 875, 224 N. Y. S. 577.

It would seem, therefore, that as to extraordinary *cash* dividends, *Matter of Osborne* (supra) is still decisive, but that as to all types of stock dividends, it has been superseded by the statutory enactment above discussed.

Yours truly,

EMANUEL SAXE.

New York, April 10, 1930.